In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 372

JOHN E. AND ESTHER D. McCULLOUGH, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioners, shareholders of the St. Louis-San Francisco Railway Company (hereafter referred to as Frisco), claim that a portion of the cash distributions they received in 1957 and 1958 exceeded Frisco's current earnings and profits and to that extent the distributions constituted a return of capital rather than a taxable dividend (Pet. 11–12). Resolution of this question depends on whether Frisco, which was reorganized in a section 77 [1] bankruptcy proceeding on January 1, 1947 (Pet. 13), is permitted to carry over a pre-reorganization deficit to offset post-reorganiza-

[1] Bankruptcy Act, c. 541, 30 Stat. 544, as amended, Sec. 77 (11 U.S.C. 205).

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tion earnings and profits. All parties agree that if the pre-reorganization deficit does not carry over, Frisco had sufficient accumulated earnings to make the full 1957–1958 distributions taxable as dividends (Pet. 4, 42).

During the 1947 bankruptcy reorganization all of Frisco's outstanding stock was eliminated and cancelled as worthless. The secured creditors received all of the new stock (Pet. 14). Every court which has considered the effect of a bankruptcy reorganization on the earnings and profits account (including the Court of Claims in the instant case) has concluded that a pre-reorganization deficit does not survive a reorganization in which the shareholders' interests are extinguished, and that such a deficit may not be used to offset post-reorganization accumulated earnings and profits. The decision below is correct and there is no conflict of decisions or other occasion for review by this Court.

1. Any distribution made by a corporation to its shareholders out of either current earnings and profits or earnings and profits accumulated since 1913 constitutes a dividend. Int. Rev. Code of 1954, § 316. Distributions in excess of earnings and profits constitute a return of capital. 1954 Code § 301(c). Congress selected accumulated earnings to serve as the yardstick in order to distinguish distributions that represent a return *of* original invested capital from those corporate distributions that represent a return *on* original invested capital (*i.e.*, a dividend).*

* See 1954 Code §§ 312, 316; Treas. Regs. §§ 1.312, 1.316.

Thus, the existence of an earnings deficit indicates that operating losses have impaired the original contributed capital and any distributions to stockholders would constitute a further impairment, *i.e.*, a return of capital.

When, as in this case, it is determined in a bankruptcy proceeding that operating losses (which are reflected in the deficit) plus declines in the market value of the assets (which are not taken into account in computing earnings and profits) have completely extinguished the stockholders' investment, elimination of the stockholders from participation in the reorganized company should also eliminate the deficit. The stockholders then recognize their losses (through worthless stock deductions—see 1954 Code § 165(g)) and their interest in the bankrupt company is closed out. Since the losses which created the deficit and eliminated the stockholders' equity interest have been recognized by the stockholders, the deficit should also be closed out.

After a new group of stockholders replaces the eliminated stockholders, it makes no sense to carry over the old stockholders' deficit. The amount of the deficit bears no relation to the new stockholders' investment in the corporation or their gain or loss. For example, assume that the original stockholders invested $1,000,000 and the bondholders loaned the corporation $200,000, that the corporation lost $1,000,000 and then went through a bankruptcy reorganization with the bondholders getting all the stock. The deficit of $1,000,000 would have no rela-

tionship to the capital invested by the new stockholders ($200,000), or to their unrecognized gain or loss on the exchange of their bonds for stock. If the deficit were carried over, the corporation could earn $1,000,000 and in a later year distribute that amount to the new stockholders without any dividend tax.

Thus, the court below correctly held (Pet. 24) that the bankruptcy reorganization "eliminated the deficit", that there was no deficit to carry forward, and that any other conclusion would have resulted in an unjustified tax benefit akin to a double deduction (once to the old stockholders as a worthless stock deduction and once to the corporation in computing dividends paid to the new stockholders).[3]

2. Every court that has considered the effect of a bankruptcy reorganization in which the stockholders are eliminated has concluded that a pre-bankruptcy deficit may not be carried forward to offset post-bankruptcy accumulated earnings. *United States* v. *Kavanagh*, 308 F. 2d 824 (C.A. 8); *Banister* v. *United States*, 236 F. Supp. 972 (E.D. Mo.), appeal to C.A. 8 dismissed; *Dunning* v. *United States*, 232 F. Supp. 915 W.D. Mo.), on appeal to C.A. 8; *Caspers* v. *Commissioner*, 44 T.C. 411. Indeed, where the stockholders have been eliminated, even a surplus in earnings is not carried forward. *Humpage* v. *Commis-*

[3] This result is also in accord with standard accounting practice. See, *e.g.*, Paton and Dixon, *Essentials of Accounting* (1958 ed.), pp. 645–649. Accordingly, no entry was made on the books of the reorganized company to reflect the claimed deficit. (Pet. 39.)

sioner, 17 T.C. 1625, acquiescence, 1962-2 Cum. Bull. 4.

Petitioners do not allege that there is a conflict in decisions among the courts of appeals but suggest that there is a "conflict in principle" (Pet. 5) between the instant decision, on the one hand, and *United States* v. *Snider*, 224 F. 2d 165 (C.A. 1) and *United States* v. *El Pomar Investment Co.*, 330 F. 2d 872 (C.A. 10), on the other. No such conflict exists. *Snider* involved a Massachusetts real estate trust (taxable as a corporation) operating two unsuccessful hotels which was reorganized into a parent and subsidiary corporation. No bankruptcy proceeding was involved and there was no material change in shareholders, assets, liabilities or business operations. Accordingly, the court held that the deficit of the trust carried over to the parent corporation.

El Pomar involved a bondholder's purchase of the assets of an unsuccessful corporation at a foreclosure sale in 1920. The assets were transferred to a new corporation in which the bondholders received new bonds and common stock. In 1929, a second foreclosure sale occurred and the assets were transferred to a third corporation. All shareholders of the second corporation continued as shareholders of the third corporation. On these facts, the court held that the deficit of the second corporation was available to offset the earnings of the third corporation. The court specifically stated that it was not holding that a deficit carried over through the first foreclosure sale (330 F. 2d at 885), and it distinguished *United States*

v. *Kavanagh, supra*, from the case before it on the ground that in *Kavanagh* the equity of the old stockholders was entirely wiped out while in the second *El Pomar* reorganization "all of the stockholders of the predecessor corporation became stockholders of the successor corporation, resulting in a continuity of stock ownership" (330 F. 2d at 884).[*] Accordingly, neither decision is in conflict with the decison below.

3. Prior to the Internal Revenue Code of 1954 (the transaction here in question took place in 1947) there was no statutory provision relating to the carryover of earnings and profits under any circumstances; judicial decisions had required corporations to carry over accumulated earnings in certain tax-free non-bankruptcy reorganizations in order to prevent tax avoidance. Since these decisions are not in any way inconsistent with the court's decision in the instant case, petitioners try to create the impression that the lower court decisions are "inconsistent and confusing" (Pet. 6), by referring to the varying views of the lower courts with regard to non-bankruptcy reorganizations which were finally resolved by this Court in *Commissioner* v. *Munter*, 331 U.S. 210, and *Commissioner* v. *Phipps*, 336 U.S. 410.

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[*] We do not suggest that *El Pomar* was correctly decided. As the court below noted (Pet. 20, fn. 16) the stockholders of the second corporation became stockholders of the third corporation only because the same individuals were also bondholders. However, the failure of the court of appeals in *El Pomar* to disregard the continuity of stock ownership on these facts and make the tax result turn on the substance of the transaction can hardly be regarded as even a "conflict in principle".

4. Indeed, this Court's decision in *Phipps* not only highlights the invalidity of petitioner's claim here but also presents an alternative basis of affirmance. That case held that the deficits of several subsidiary corporations could not be used to offset the earnings of the parent corporation after a tax-free liquidation of the subsidiaries. This Court explained that allowance of a deficit carryover would permit the premature recognition of losses the tax effects of which Congress intended to defer when it made the liquidation of a subsidiary into a parent nontaxable. 336 U.S. at 421. Since the reorganization here was nontaxable with respect to both the corporation and the bondholders who became shareholders, permitting a deficit carryover would result in exactly the same premature recognition of deferred tax effects that was condemned in *Phipps*.

5. In Section 381(c)(2) of the Internal Revenue Code of 1954, Congress for the first time created specific statutory rules governing the carryover of earnings and profits in certain tax free reorganizations. Although taxpayers admit that this provision is not applicable to the reorganization involved here, they seem to imply that if the 1954 Code were applicable they would be entitled to the claimed carryover (Pet. 8). However, by failing to include Section 381(a) in their statutory appendix, taxpayers have simply glossed over the fact that Section 381 does not apply to insolvency reorganizations at all.

6. The decision below is entitled to affirmance on a separate and alternative ground that the Court of

Claims had no occasion to reach. Frisco's entire deficit was attributable to the accrual of interest on its defaulted bonds, which interest was discharged by the reorganization. Frisco's pre-1947 deficit was approximately $51,000,000; at least $101,000,000 of accrued interest was discharged in 1947 as a part of the bankruptcy reorganization. (Pet. 13–14, 37, 41.) Accordingly, the amounts deducted from earnings and profits when the interest accrued must be restored to earnings and profits when liability for the accrued interest was discharged. Therefore, no pre-organization deficit exists. See, *e.g.*, Rev. Rul. 58–546, 1958–2 Cum. Bull. 143; 1 Mertens, *Law of Federal Income Taxation* (Rev. 1962) § 9.32.

For these reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.
RICHARD M. ROBERTS,
Acting Assistant Attorney General.
PHILIP R. MILLER,
FRED R. BECKER,
Attorneys.

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